



January 2016 Thoughts and Insights

We would like to start the first letter of the New Year by wishing all of you a very healthy, happy, and prosperous 2016. Needless to say, this past year was a difficult one for all investors. 2015 kicked off with a very cold winter which caused an economic slowdown in the US, and the headlines from Greece declared a possible messy exit from the Eurozone. During the summer a weakening Chinese economy led to the surprising devaluation of the yuan and strengthening of the dollar. In August this news helped trigger a massive drop in the U.S. equity markets. As the fall began, markets grew uneasy over the increasing prospects of a rate increase by the Fed. A fourth quarter meltdown in commodities hurt resource-based industries, suggesting the possibility of a global recession. Geopolitical crises, terrorism and a bizarre U.S. election year backdrop have all also helped boost uncertainty.

Due to all these uncertainties, last August we reduced our exposure to equities with the plan to reinvest over a 6 week to 6 month time horizon. As the year closed, we did not find reason to reinvest and we remain heavy in cash for our equity allocations, which helps to soften the macro downturn in stocks.

The US markets ended the year lower with the Dow down (-2.2%) and the S&P 500 down (-0.73%). We have always used these market indexes as a comparison to your portfolios due to their widespread use by the press as an indication of how the general US markets performed. However, it is very important to note that these indexes are “cap-weighted” which means that a company’s size matters in the calculation of the index performance. This past year four stocks, nicknamed FANG for Facebook, Amazon, Netflix and Google, ruled the index earning over 60% on a cap-weighted basis. Excluding those four stocks, the S&P 500 was actually down (-4.8%) last year. This proves that comparing results to the S&P 500 is not always relevant to individual portfolio performance.

The weakness in our portfolios came mainly from the energy sector. The combination of over-supply in oil and the political game of chicken between Saudi Arabia and the other OPEC partners has caused a dramatic decline in the price of crude. We have owned MLP’s (mid-stream energy pipelines and not oil producers) in our portfolios for over 15 years due to their long standing steady income stream through dividends. These companies make their money by the transit of oil through pipelines. Their contracts are based on the flow from point A to point B across America, and US consumption (or demand) has not changed. Their decrease in price is due to guilt by association, a classic case of the baby being thrown out with the bath water. As long as Americans keep driving their cars, pipelines will remain in business. However, we are keenly watching their dividend payout levels. If they should have trouble maintaining their payouts, we will re-assess their investment viability.

As we look forward, in many ways 2016 may resemble 2015. We believe that the US is still growing, albeit very slowly. Unemployment levels are low, and wage inflation should arise this year as companies cannot find skilled labor and will ultimately be forced to raise wages. This is very positive for the consumers in the US, and we eagerly look forward to investing in more consumer related companies when the current market corrections subside. The Fed's modest rate increases should not create any headwinds for growth. We are cautious, however, as earnings growth must improve for prices to advance. As long as global growth increases earnings should recover. If profits expand even modestly, valuations will increase. The bull market is maturing, not dead, which means gains will be modest.

On the fixed income side, the interest rate increase by the Fed did not cause a price shock to bonds. We continue to hold securities that are not overly sensitive to rising rates, have shorter maturities, and are high dividend paying securities. This strategy has brought stability to your portfolios over the past year and should continue in 2016. When rates do rise, the cash from our maturing bonds will be reinvested at higher rates.

The negative volatility that we are currently experiencing is reminiscent of markets in 2009, 2003, and 1998. These markets did indeed test our intestinal fortitude, but by staying focused on our primary investment objectives, holding on to our solid investments, and riding out the panic, our portfolios have always recovered. We feel fortunate to have cash available to buy great investments at cheap prices once the volatility settles.

As always, we remain dedicated to the prudent stewardship of your investments. We invite you to call, write, or stop by anytime with any questions you may have.

Michelle & Jim